STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	)	
	)	Docket No. 04-0442
Proposed general increase in water rates.	)	

INITIAL BRIEF OF AQUA ILLINOIS, INC.

Dated: December 10, 2004

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I.
Introduction

Aqua is requesting a revenue increase for its Vermilion Division of $1,492,209 or 13.85%[1] as adjusted for the known and measurable increase in rate case expense to $1,526,324 or 14.16%. This equates to a modest increase of only 3.54% annually since Aqua's last rate case for its Vermilion Division four years ago. Aqua has shown this moderate increase to be entirely reasonable, especially given the capital additions Aqua has made to its system since 2000. In addition to the Indianola acquisition, the Division has 20.4% more gross utility plant-in-service than in 2000 and Aqua projects a further 11.4% to occur by December 31, 2005. Such significant plant increases drives increases in costs. Nonetheless, Aqua has shown its ability to provide quality service and at the same time manage costs in this environment. In fact, while labor is a major cost that is generally increased by plant additions, Aqua's requested Payroll Expense is $68,534 *lower* than the Commission approved for Vermilion in 2000. Aqua believes its requested 3.54% annual increase is demonstrative of the fact that the Company has controlled its costs effectively while maintaining service quality.

Furthermore, Aqua has shown that its requested increase is based on a sound and reliable budget for the future 2005 test year. The budget was developed carefully based on the most recent information available and needs known. The independent accounting firm London Witte Group, Inc. ("London Witte") examined the budget closely. London Witte concluded the budget is in full conformity with the American Institute of Certified Public Accountants' guidelines, and that the necessary assumptions underlying the budget provide reasonable bases for the future test year projections. London Witte's determinations have not been challenged.

[1] Aqua originally requested a revenue increase of $1,538,903 or 14.28% but, during the course of this proceeding, accepted certain of Staff's proposed adjustments and proposed its own adjustments for known and measurable changes. This latest number reflects Aqua's acceptance of Staff's proposed short- and long-term debt costs.

Staff has, however, proposed adjustments to Aqua' budget for the 2005 future test year. In total, the following are the outstanding differences by issue between Staff and Aqua, with Staff proposing reductions to Aqua's revenue requirement by these amounts:

Account	**Amount at Issue**
Return on Equity	(244,120)
Payroll Expense	(90,129)
Payroll Taxes	(12,186)
Incentive Compensation	(33,790)
Collections/Mgt. Fees	(19,246)
Advertising	(9,540)
Charitable Contributions	(27,675)
Rate Case Expense	(34,000)[2]
Working Capital - Other[3]	(4,663)

None of Staff's adjustments should be adopted for a variety of reasons, including that they lack support, are historical when the test year is future, are one-sided and are in direct conflict with the Commission's rulings on the very same issues in April, 2004.[4]

For these reasons and more, as discussed herein, Aqua respectfully requests that the Commission reject Staff's proposed adjustments and approve Aqua's requested revenue increase of $1,526,324 or 14.16%.

II.
Argument

A. Rate Base

There are no issues related to rate base outstanding between Aqua and Staff.

[2] Aqua actually has proposed to increase its rate case expense by $102,000 (amortized over three years at $34,000 annually) because it is a known and measurable change. It is represented here as a proposed negative adjustment by Staff because Staff has opposed the increase.

[3] This includes a small amount that reflects interest synchronization based on Aqua's proposed numbers as discussed herein at page 27.

[4] In total, Staff proposes three adjustments that conflict with past Commission Orders in Aqua rate cases: incentive compensation, a risk adjustment for Aqua's NAIC-2 rating and rate design for the Large Industrial Customer Class, *i.e.*, Teepak.

B. Operating Expenses

1. Payroll Expense: Aqua Has Fully Supported Its Payroll Expense Budget

Aqua's surrebuttal reflects a budgeted $1,087,387 in Payroll Expense for the 2005 test year. (Aqua Ex. S-2.0, p. 16). The evidence establishes this amount has been projected based on the most recent information known and available in accordance with all applicable accounting guidelines. It has been certified to as being properly budgeted by London Witte. Staff has not contested Aqua's compliance with the appropriate budgeting standards. (Tr., pp. 243-44).

Importantly, the amount budgeted is $68,534 *lower* than the amount the Commission approved for Vermilion in the 2000 rate case. (Aqua Ex. S-2.0, p. 16). In Docket No. 00-0339, the Commission approved a revenue requirement that included $1,155,921 for payroll expense. (Aqua Ex. R-2.0, p. 18). This is solid evidence demonstrating that Aqua has maintained, and in fact reduced, its costs since 2000.

Aqua has done so despite the presence of significant factors that drive cost increases. Since the Commission's last rate Order, Aqua has had a 20.4% increase in gross utility plant-in-service. (*Id.*) This significant growth is in addition to the Company's acquisition of the Indianola system, which occurred in October 2003. (*Id.*) A further 11.4% increase in water utility plant-in-service is projected to occur by December 31, 2005. (*Id. citing* Aqua Sch. B-5, p. 1, ln. 49). Such growth is a large cost driver because additional labor is required to operate and manage the additional plant. Aqua's $68,534 reduction of its Payroll Expense in the face of what is projected to be a more than 31.8% increase in utility plant-in-service demonstrates Aqua's effective management of its labor costs and should be commended.

Nonetheless, Staff proposes to reduce Aqua's budget for Payroll Expense even further by an additional $90,129. The evidence demonstrates that Staff's proposal is erroneous for many reasons and should not be adopted by the Commission. However, if the Commission adopts the adjustment, which it should not, the rational for doing so should be applied consistently, and an adjustment to Outside Contractual Services – Other also should be made.

a. Staff Did Not Assess The Expenses Expected To Be Incurred In 2005

The sole basis for Staff's adjustment is the occurrence of a *historical* budget variance during the 2001 to June 2004 period. However, in this case, Aqua is using a future test year, which is a tool that enables the Commission to set revenue requirements to more accurately reflect costs that will be incurred during the future periods when the revenue requirements will be in effect. To be accurate, the costs reflected in the revenue requirement must be the costs expected to be incurred during the future period. As such, a *future* budget is at issue in this case. If a budget is designed historically rather than to reflect conditions anticipated during the future year, then the budget will not contain relevant or useful information for the future revenue requirement.

Yet, designing Aqua's future budget to reflect history rather than anticipated future conditions is exactly what Staff attempts to do through its Payroll Expense adjustment.[5] Staff admitted that the historical budget variance is the only basis for its proposed adjustment. (Tr., pp. 241-42). Staff did not conduct any examination into whether Aqua's budgeted Payroll Expense actually reflects labor costs Aqua expects to incur in 2005. (Tr., pp. 241-43). Nor did Staff examine whether the historical conditions that caused the historical budget variances are projected to exist in 2005 (or any other future year for that matter). (Tr., pp. 247-48).

The evidence establishes that two factors interceded to cause the historical budget variances upon which Staff relies and that these factors are not projected to exist in the test year.

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[5] Aqua does not mean to imply that historical performance is irrelevant *per se*. Rather, it is Aqua's position that historical performance must be viewed in the correct context in that determinations must be made as to whether factors that influenced historical performance will continue to exist in the future and influence future performance in the same way.

The two factors were: (i) the occurrence of significant but unanticipated capital projects,[6] and (ii) employee position vacancies. (Aqua Ex. R-2.0, pp. 14-15). The first factor caused existing in-house labor to be redirected to the capital projects and accounted for as Capitalized Payroll. (*Id.*) The second factor redirected Payroll Expense into Unpaid Overtime by other employees and outside contractual services.[7] (*Id.*; *see also*, Aqua Ex. S-2.0, p. 11).

Staff obviously could not identify any unanticipated capital projects that are anticipated to occur in 2005. (Tr., p. 247). Staff also admitted it had not examined whether the position vacancies would remain. (*Id.*) While Staff had every opportunity to ask questions in this regard, none were made:

> Q. Do you know whether, if there are current position vacancies, do you know whether the Company is in fact in the process of conducting interviews for those positions?
>
> A. No.
>
> Q. Do you know whether the Company has posted those vacancies for public notice?
>
> A. No.
>
> Q. You have not asked the Company in a data request what steps it is currently taking to fill any vacant positions, have you?
>
> A. My adjustment was not based on positions and so, no, I didn't ask any questions regarding positions.

(*Id.*)

[6] In total, the Company added $1,438,518 more in Property, Plant and Equipment than was expected during the 2001 to 2003 period. (Aqua Ex. R-2.0, p. 15).

[7] While position vacancies existed during the 2001 to June 2004 period, the duties associated with the positions still existed and had to be performed. Aqua relied on other employees to work unpaid overtime and outside contractual services more heavily to cover the vacancies. (Aqua Ex. R-2.0, p. 14-15; Aqua Ex. S-2.0, p. 11).

Although Staff did not conduct such an examination, Aqua did and has submitted evidence that the conditions causing the historical budget variances are not projected to exist in 2005 or other future years. Unanticipated capital projects, by their very nature, are not possible to predict and, thus, cannot be reflected in a budget. Aqua properly prepared a budget based on the actual amount of capital projects anticipated for the test year. (Aqua Ex. R-2.0, pp. 16-17). Employment vacancies also are not projected to influence the 2005 budget. (Aqua Ex. S-2.0, p. 11). Aqua is actively engaged in efforts to fill the vacant positions. It is expected that the positions will be filled by the end of the current year or shortly thereafter. (*Id.*) Aqua's budget properly reflects the expectation that vacant positions will be filled. (Aqua Ex. R-2.0, p. 15).

Accordingly, the evidence establishes that while historical budget variances may have occurred, those variances were caused by factors that are not expected to exist during the 2005 test year. The Commission should set Aqua's revenue requirement to reflect the expenses projected for the future test year. It should decline to follow Staff proposal to target Aqua's future budget to historical periods.

b. Staff's Adjustment Likely Would Produce Substantial Budget Variances

If conditions causing a budget variance cease, then, all things being equal, the variance itself will cease. Staff agrees with this principle.[8] (Tr., p. 249). Accordingly, it is inappropriate to rely on the historical budget variances as Staff does because the variances are not projected to continue. The variances are not projected to do so because the causes for the variances are not

[8] Staff witness Ms. Ebrey testified under cross-examination as follows:

> Q. Okay. For example, if the budget variance was in fact created by position vacancies and the occurrence of unanticipated events, and the positions were filled and no unanticipated event occurred, then the variance should cease, should it not?
>
> A. Hypothetically, yes.

(Tr., p. 249).

projected to continue. Incorporating such variances into future budgets irrespective of these facts would only serve to create future budget inaccuracies.

Indeed, this likely result is demonstrated by a retroactive application of Staff's proposed adjustment. Although a portion of payroll expenses was temporarily not incurred during the historical period Staff relies upon, the associated costs remained. (Aqua Ex. R-2.0, pp. 14-15). As explained *supra*, some of the costs were redirected to Capitalized Payroll, other costs to outside contractual services, and still other costs were made up by employees committing their individual resources to work unpaid overtime. Thus, it is important to recognize that while Payroll Expense, a single account line item, may have had a temporary below budget accounting variance, increases in other areas clearly offset the reduction. Staff's analysis fails to consider these unrebutted facts.

Staff asserted during hearing that its adjustment is based on total payroll and, thus, recognizes historical variances in Capitalized Payroll as well as Payroll Expense. (Tr., p. 121). But, such an explanation fails to recognize that only part of the Payroll Expense variance was redirected to Capitalized Payroll. The other part of the variance was redirected to Outside Contractual Services – Other and to individual employees working unpaid overtime. Neither of those latter offsetting variances are accommodated by Staff's consideration of total payroll as opposed to only payroll expense.

The fact that the costs associated with position vacancies remained and were redirected in part to other accounts, like outside contractual services, is the reason for the overall accuracy of Aqua's budget. The evidence establishes that the Company's total operating expense budget for the 2001 to 2003 historical period was highly accurate. The Vermilion Division had an actual O&M expense variance of only .82% over the combined three year period. (Aqua Ex. R-2.0, pp. 10-11 *citing* Aqua Ex. 5, Sch. G-1, p. 2, ln. 3). Similarly, the Vermilion Division had an actual Utility Operating Expense variance over the combined three year historical period of only .46%. (*Id.*, p. 11 *citing* Aqua Ex. 5, Sch. G-1, p. 2, ln. 12). Aqua had budget variances of *less than a single percent* over the combined three year period. Clearly, Aqua accurately budgeted for the historical period even though some payroll expenses were redirected to other areas. (Aqua Ex. S-2.0, p. 14). Staff has not, and cannot, rebut this fact.

Had Staff's proposed adjustment to Payroll Expense been imposed during the historical period a substantially different result would have occurred. The Division's combined O&M expenses for the three years would have been off by $436,969 or 4.13% in a negative direction. (*Id.*) Similarly, Vermilion's Utility Operating Expenses would have been off by $447,565 or 2.07%, again in a negative direction. (*Id.*) This demonstrates that while Staff states an intent to correct budget variances, the actual results would likely be the opposite of Staff's stated intent.

c. Staff's Adjustment Would Impact Jobs

Staff has been clear that its proposal is not based on jobs. It has not recommended the elimination of any employment position. (Tr., p. 237). It has not identified a single position that is allegedly unnecessary or unjustified. (Tr., p. 238). Yet, the reality is that the adoption of Staff's proposed adjustment will impact, in all likelihood, peoples' jobs.

Staff's proposed adjustment would produce a Payroll Expense budget that is a substantial $158,663 *below* the amount the Commission approved for the very same Division in the 2000 rate case. (Aqua Ex. S-2.0, p. 11). The consequence of this adjustment would be the elimination of funds to hire individuals to fill the currently vacant positions or the reduction of employee wages in real dollars. (*Id.*, pp. 16-17). Such an adjustment is inappropriate and contrary to the efficient manner in which Aqua has operated its Vermilion Division.

Staff's adjustment also would raise the related concern as to the impact on service quality. Aqua witness Mr. Schreyer explained:

> Staff's [] adjustment of an additional ($90,129), which would produce an adjusted payroll expense that is $158,663[9] *below* what the Commission approved in Docket 00-0339, could have the very real and serious potential to negatively impact the Company's ability to operate and manage its plant. The Company prides itself on providing quality service to its customers and believes it has demonstrated its consistent quality of service, but the Company needs the necessary personnel to accomplish this end. Staff's adjustment would place the Company in a position of either reducing employee levels, despite the 20.4% increase in plant-in-service to operate and manage, or reducing wages in real dollars, an action that would be extremely detrimental to the Company's ability to retain quality employees or attract new ones.

(*Id.* (emphasis in original)(footnote added)). This result would not send appropriate policy signals.

d. If The Commission Accepts Staff's Payroll Adjustment, It Should Make A Consistent Adjustment To Contractual Services

As discussed *supra*, the evidence establishes that Aqua accounted for position vacancies, in part, through a greater reliance on outside contractual services. As a result, Aqua's account for Outside Contractual Services – Other experienced a very similar historical variance to its account for Payroll Expense. The variances in each account were of virtually the same amounts. The only difference was that the two variances occurred in opposite directions. The Payroll Expense variance was below-budget whereas the Contractual Services variance was above-budget. (Aqua Ex. R-2.0, pp. 13-14). Aqua witness Mr. Schreyer explained:

> If the Company's historical budget is viewed accurately, it is clear that while a portion of the Company's costs may not have been allocated to Payroll Expense in 2001 to 2003, the Company still incurred those costs. They were simply redirected to Contractual

[9] The original contained an incorrect reference to $168,534 and is corrected to $158,663 herein.

> Services. This is clear by the fact that the Company came so close to its overall O&M budget - within a half percentage point.

(*Id.*, p. 14).

Staff proposes to adjust Payroll Expense, thereby reducing Aqua' revenue requirement, but refuses to make a similar adjustment to Outside Contractual Services – Other. Staff does so even though it admits that historical budget variances have occurred for Outside Contractual Services. (Tr., pp. 249-50). Staff even agrees to the virtual identical amount of the variances:

> Q. And would you agree with Mr. Schreyer's testimony, and I will point to page 13 of his rebuttal testimony, where he states on lines 268 to 271 that Contractual Services Other for the year 2001 through 2003 was over budget by a combined $327 -- I am sorry, $327,778?
>
> A. I see that line.
>
> Q. And you have not disputed that calculation, have you?
>
> A. No.
>
> Q. And would you agree with me subject to check that on average that equates to a variance of $109,259?
>
> A. Subject to check.

(*Id.* (compare the $109,259 average to the $90,129 Staff requests for Payroll Expense)).

Staff maintains, nonetheless, that it has not observed a historical budget variance in Outside Contractual Services that is "similar" to the one observed in Payroll Expense. (Staff Ex. 6.0, p. 5). Such a position conflicts directly with the variance numbers cited by Mr. Schreyer in his testimony with which Staff agrees. (Tr., p. 249). Outside Contractual Services - Other has experienced historical variances just like Payroll Expense.

The only explanation that can be inferred from Staff's testimony lacks factual support. Staff argues incorrectly that an adjustment does not need to be made to Outside Contractual Services – Other simply because Aqua's 2005 budget for the account is greater than the amount historically budgeted. (Staff Ex. 6.0, p. 5; Tr., p. 252). However, Staff has stated that it does not know why the budget for that account has been increased, or whether the increased amount would account for the historical variances. Under cross-examination, Staff witness Ms. Ebrey repeatedly testified that she could not explain why Aqua increased its budget for Outside Contractual Services or what expense items are represented by the increased amount. (Tr., pp. 250-54). Staff's position, therefore, is unsupported.

Moreover, Staff's position disregards actual evidence establishing that the increase does not account for historical variances. The evidence shows that the increase reflects the incorporation of an expense—sludge hauling—that was budgeted previously to be charged to a balance sheet reserve account. (Aqua Ex. S-2.0, pp. 13-14; Aqua Cross Ex. 2, p. 2 (Aqua Res. to TEE 5.10)). Adding the sludge hauling expense caused the Contractual Services budget to increase by $166,860. (*Id.*) Without the sludge hauling expense, Aqua's 2005 budget for Outside Contractual Services – Other actually decreases by $122,512. (*Id.*) Making this apple-to-apple comparison, Aqua has set a budget for the account that is below the amount historically budgeted by more than the average historic variance of $109,259. (*Id.*) Staff does not dispute this evidence. (Tr., pp. 254-55). Accordingly, the evidence establishes that although Staff may visually perceive an increase in the budget for Contractual Services, the $166,860 increase is artificial in the sense that it represents the addition of the sludge hauling expense, previously charged to a balance sheet reserve account, rather than an increase in the expenses budgeted historically to Contractual Services.

It is clear, therefore, that Staff has taken a one-sided approach. Aqua believes that it has met its burden of demonstrating that its budgeted Payroll Expense is reasonable and that Staff's adjustment to Payroll Expense is erroneous. Nonetheless, if the Commission accepts Staff's Payroll Expense adjustment, the Commission should apply Staff's rationale for doing so consistently and adjust Outside Contractual Services–Other as well. It would be inequitable, as well as arbitrary and capricious, to do otherwise.

2. Payroll Taxes: Staff's Payroll Tax Calculations Must Be Modified To Reflect Aqua's Payroll Expense

a. FICA Tax

Aqua agrees with the manner in which Staff calculated the FICA Tax but, as explained *supra*, disagrees with the Payroll Expense amount Staff utilized to perform the calculation because Aqua does not agree with Staff's proposed ($90,129) adjustment to Payroll Expense. The correct Payroll Expense to be used in the calculation is $1,392,103. (Aqua Ex. S-2.0, p. 3).

b. Capitalized Payroll Tax

Aqua agrees that the appropriate Capitalized Payroll percentage should be applied to Payroll Tax Expense and that $304,716 is the proper amount of capitalized payroll. However, Aqua disagrees with Staff's proposed capitalized payroll percentage, again because Aqua disputes Staff's proposed ($90,129) adjustment to Payroll Expense. The appropriate payroll expense to use in the calculation of the percentage is $1,392,103, which produces a Capitalized Payroll percentage of 21.89%. (Aqua Ex. S-2.0, p. 4).

c. SUTA And FUTA

Aqua accepts Staff's method of calculating SUTA and FUTA, but is not in agreement on the proper amount of these taxes to be capitalized. As set forth *supra*, the proper Capitalized Payroll percentage is 21.89%. (Aqua Ex. S-2.0, p. 4).

3. Incentive Compensation: Aqua's Expenses For Incentive Compensation Should Be Recovered

In April 2004, in the Order approving rates for Aqua's Kankakee Division, the Commission found that "as a whole" Aqua's incentive compensation program is reasonable and that Aqua's expenses incurred pursuant to the program are recoverable. Order, Dkt. No. 03-0403, p. 15 (2004). In this proceeding, Aqua presented evidence demonstrating that the *same* incentive compensation plan[10] is being used for the Vermilion Division, (Aqua Cross Ex. 4), and that the program's costs are reasonable. Remarkably, Staff opposes Aqua's recovery of these expenses and raises issues with regard to Aqua's incentive compensation program that are substantially similar to those the Commission resolved less than nine months ago. Aqua respectfully states that Staff's proposed adjustment is contrary to both the evidence in this proceeding and the Commission's recent Order in Docket No. 03-0403.

a. Staff's Adjustment Is Contrary To The Order In Docket No. 03-0403

The Commission already has held that expenses incurred under a plan that is materially the same in all relevant respects as the one at issue here are recoverable. In Docket No. 03-0403, the Commission ruled:

> As a whole, the program appears to set targets for a broad range of objectives, rather than tying compensation directly to earnings performance. Many of the goals established by the Company promote ever-increasing water quality, customer service, and system safety. While investors may derive some benefit from certain cost reduction goals, the Commission is of the opinion that ratepayers are the primary beneficiaries of the incentive compensation program as a whole.

(Order, Docket No. 03-0403, p. 15). In fact, the Commission has allowed Aqua's recovery of expenses associated with its incentive compensation plan since 1997, albeit in 2000 the

[10] The evidence demonstrates that the plan for which expenses are under consideration for recovery in this case is the same plan in all material respects as the plan considered in Docket No. 03-0403. Both plans were introduced into the record as Aqua Cross Ex. 4.

Commission did so as part of a settlement wherein Staff has nonetheless recommended the expenses' recovery. (*See,* Amended Order, Dkt. No. 97-0351, p. 16 (1998); Order, Dkt. No. 00-0339, p. 5 (2001)).

Staff acknowledges that Aqua's expenses associated with its incentive compensation plan should not be disallowed because of any dissimilarity between the plan under consideration here and the one considered in Docket No. 03-0403. Staff has clearly stated its position that it does not propose to disallow Aqua's expenses "based on dissimilarities between the plan reviewed in this case and the plan reviewed in Docket No. 03-0403." (Tr., pp. 258-59; Aqua Cross Ex. 3). When Staff has not even advanced such a position, the record clearly would not support a finding of any dissimilarities upon which the Commission could rely to reach a disparate result in this case.

b. Staff's Proposed Adjustment Is Contrary To The Substantial Evidence That Ratepayers Benefit From Aqua's Incentive Compensation Plan

It is Aqua's position that the Commission does not need to go any further in its analysis of the issue given the ruling in Docket No. 03-0403. Should the Commission, nonetheless, decide to re-evaluate Aqua's recovery of these expenses for some reason, the evidence establishes that the Commission's standard for recovery is satisfied fully. In particular, the record demonstrates that ratepayers benefit from Aqua's plan, just as the Commission found in Docket No. 03-0403.

The Company's incentive compensation plan is designed to bring benefits to ratepayers. (Aqua Ex. R-2.0, p. 23). Customers benefit from employees' individual objectives being met because they are targeted toward controlling costs, improving efficiencies and enhancing customer service. (*Id.*) These accomplishments further result in mitigating the need for rate relief. (*Id.*) Staff agrees that when employees create efficiencies or reduce expenses on a going-forward basis, consumers benefit. (Tr., pp. 263-64). These beneficial end results to ratepayers are fully demonstrated by the fact that four years elapsed since Aqua last sought rate relief for Vermilion and now is requesting only a 3.54% annual increase despite significant additions to rate base. (Aqua Ex. R-2.0, p. 23).

The Company also introduced evidence of fifty-one separate examples of employees achieving goals under the plan that promoted ever-increasing water quality, customer service and system safety, many of which are measurable both tangibly and quantifiably. (Aqua Ex. S-2.0, pp. 18-19, Sch. S-2.2). While all of the examples are set forth in Schedule S-2.2, Aqua witness Mr. Schreyer pointed out some examples specifically:

> VER 024545 notes an employee coordinating the safety-related Vulnerability Assessments as 'instrumental in obtaining a $115,000 grant form (sic) the Federal Government.' That same document notes an employee overseeing a collections program that results in 'uncollectibles at an all time low level.' VER 023438 reflects an employee leading a team of operators 'to the first ever PERFECT score on the bacteriological testing certification...' VER 024549 shows an employee reducing the cost of lift stations monitoring by $6,854 or 69%. VER 024551 notes an employee being instrumental in saving the Company 'thousands of dollars in contractual engineering and design fees.' VER 023444 reflects increased collection efforts that 'resulted in the collection of $232,000 from delinquent customers in 2003.'

(*Id.*, p. 19). This evidence fully establishes that Aqua's plan promotes customer benefits of the exact type the Commission requires.

Staff asserted, however, during the evidentiary hearing that some of Aqua's examples pertain to employees that are not in the Vermilion Division. Such criticism is a non-starter. Mr. Schreyer testified in response to such questioning that the Company's incentive compensation plan is the same throughout Aqua. (Tr., pp. 118-19, 135). He explained that examples of employee achievements, regardless of Company Division, show the very type of achievements that the plan prompts employees in all Divisions, including Vermilion, to achieve.

(*Id.*) Moreover, many of the examples pertain specifically to Vermilion employees and still others pertain to corporate level employees whose achievements benefit all underlying Company divisions. (Aqua Ex. S-2.0, Sch. S-2.2). Mr. Schreyer testified to his opinion that the goals achieved by several of the Vermilion employees specifically benefited ratepayers. (Tr., 136-37). Accordingly, the evidence establishes that Aqua's incentive compensation plan establishes the correct incentives for employees to achieve customer-oriented goals and that consumers do, in fact, benefit from the plan.

Staff's remaining objections also are unpersuasive. In total, Staff advanced five reasons to disallow Aqua's recovery of these expenses. (Staff Ex. 6.0, p. 10). Aqua witness Mr. Schreyer fully rebutted each of the reasons asserted:

- Staff Reason #1: "The plan is dependent upon financial goals which benefit shareholders and not ratepayers."

  Aqua Response: The fifty-one examples set forth in Schedule S-2.2, plus the ultimate result that rate relief is mitigated by the achievement of goals under the plan, (Aqua Ex. R-2.0, p. 23), fully rebut Staff's allegation that ratepayers do not benefit from Aqua's plan. Further, the Commission already found in Docket No. 03-0403 that compensation under Aqua's plan is not tied directly to earnings. It recognized that while shareholders will receive some benefits from the plan, that fact, in and of itself, is not sufficient to disallow recovery. It stated that "[w]hile investors may derive some benefit from certain cost reduction goals, the Commission is of the opinion that ratepayers are the primary beneficiaries of the incentive compensation program as a whole." (Order, Dkt. No. 03-0403, p. 15).

- Staff Reason #2: "The goals in the plan may not be met and thus no cost would be incurred by the Company yet ratepayers would have provided funding."

  Aqua Response: Staff's assertion that funds may not be paid is pure speculation. Moreover, the evidence supports the exact opposite conclusion. When asked about specific knowledge of Aqua's payment history, Staff admitted it did not know the information. (Tr., p. 262). However, Aqua has paid incentive compensation every single year since 1995. (Aqua Ex. S-2.0, p. 20). Between 2001 and 2003, Aqua paid a total of $110,478. (*Id.*) Speculation that such payments will not continue is not supported by the evidence.

- Staff Reason #3: "The plan is discretionary and may be discontinued at any time."

> Aqua Response: Staff's assertion that the plan may be discontinued is again speculation. The Company's maintenance of the plan and consistent payment of incentive compensation since 1995 shows the exact opposite historical occurrence from what Staff speculates may take place in the future. Further, Aqua's testimony is clear that it considers the plan an important part of its compensation program to attract and retain quality personnel. (Aqua Ex. R-2.0, pp. 22-23). The fact that Aqua has budgeted to make future payments shows its clear commitment to maintaining the program. (Aqua Ex. S-2.0, p. 20). As Mr. Schreyer testified "[t]he Company has already exercised its discretion to continue the plan." (*Id.*)

- Staff Reason #4: "There is not sufficient comparable historical data on which to determine if the test year level is reflective of a normal level."

> Aqua Response: The evidence is that for 2001 to 2003, Aqua paid $110,478 in incentive compensation, which equates to $36,826 on average annually. (Aqua Ex. S-2.0, p. 20). This payment history fully supports Aqua's 2005 budget of $33,790, which is even less than the historical annual average.

- Staff Reason #5: "The disallowance of incentive compensation is consistent with prior Commission Orders."

> Aqua Response: Staff's fifth reason is obviously surprising given the Order in Docket No. 03-0403. Staff does not mention that Order, and instead relies on Orders that addressed entirely *different* plans than the one at issue in this case.

Accordingly, the evidence establishes that Aqua's expenses associated with its plan are recoverable, just as the Commission has determined in Docket No. 03-0403. The evidence of benefits to consumers promoted by the plan has not been rebutted. Staff reasons for disallowing recovery are not persuasive. The Commission should hold, consistent with its Order in Docket No. 03-0403, that Aqua's incentive compensation expenses are recoverable.

4. Collections Expense: Staff's Proposes An Inappropriate Double Adjustment

Aqua included $19,246 in Collections Expense within its budget for Miscellaneous General Expense. In response to Staff's recommendation, Aqua removed the expense in its rebuttal case. (Aqua Ex. R-2.0, pp. 25-26 (referencing this adjustment as the first part of Staff's Collection Expense adjustment); *see also, Id.*, Sch. R-2.1, p. 1, ln. 14). Staff agrees that Aqua made this adjustment. (Staff Ex. 6.0, p. 24; Tr., pp. 230-31).

Nonetheless, Staff seeks to remove the exact same expense item, *i.e.*, $19,246 in Collections Expense, again from the Company's budget, this second time from the Company's budget for Management Fees. (Tr., p. 232). Staff witness Ms. Ebrey testified on cross-examination as follows: "it appeared to me that the Company had included that 19,246 twice in their revenue requirement, once as collections under Miscellaneous General Expenses and also in Management Fees." (Tr., p. 231). However, Ms. Ebrey was unable to identify any support for her belief. (Tr., pp. 233-35). Instead, she testified that her proposal is based only on her own "presumption," unsupported by any evidence. (Tr., p. 234).

In fact, her presumption conflicts with the evidence on the issue. Ms. Ebrey admitted that she did not know which expenses Aqua included in the budget for Management Fees (Tr., pp. 233-35); but, in TEE 7.06, Staff specifically asked if Aqua included the $19,246 in the budget for that account. Aqua answered unequivocally "No." (Aqua Cross Ex. 1).

Accordingly, there is no evidentiary basis for the double adjustment Staff proposes. The evidence only supports a finding that Aqua included the $19,246 Collections Expense in its budget a single time and it has been removed a single time. Aqua did not include the expense a second time in Management Fees. (*Id.*) The Commission should reject Staff's adjustment.

5. Advertising Expense: Staff's Adjustment Would Disallow Expenses For Important Customer-Informative Advertisements

Staff proposes to disallow 5$9,246 of the Company's advertising expenses. Of this amount, Staff proposes to disallow the Company's requested $3,000 increase in newspaper advertising expense as being unsupported. (*Id.*, p. 19). The remainder Staff proposes to disallow constituting good-will advertising that is not informative to consumers. (Staff Ex. 2.0, pp. 17-18, Sch. 2.7). In drawing these later conclusions, however, Staff did not investigate how consumers or the community interest groups perceive the advertisements. Staff did not ask the consumers or interest groups for their opinions whether Aqua's advertisements provide important information. (Tr., p. 264). Staff simply advances its own subjective opinion, which, it has become clear is not in line with consumers as Staff's opinion is that consumers *do not* benefit from receiving information on projects that impact important matters like water quality and water service:

> Q. Ms. Ebrey, do you think that a customer benefits from having information as to a utility's projects that impact service?
>
> A. I don't know how that would benefit a customer having that information.
>
> …
>
> Q. Do you have an opinion as to whether a customer benefits from receiving information as to an upcoming project that would impact water quality?
>
> A. No.

(Tr., pp. 266-67).

a. Aqua's Advertisements Are Designed To Inform Consumers

Aqua witness Mr. Schreyer testified that Aqua does not engage in promotional advertising because Aqua is not in a competitive industry and, therefore, has no need to do so. (Aqua Ex. R-2.0, p. 27). Because Aqua is the only water service provider that the Commission has certificated to provide service in the Vermilion area, it is not necessary for Aqua to encourage consumers to select or use its service. (*Id.*) This is strong evidence that Staff's subjective opinion as to the purpose for disallowing Aqua's radio advertisements is incorrect. The content of the advertisements, which are in large part divided into three categories, completely dispel any remaining question as to the benefit consumers receive from the advertisements.

i. Advertisements To Inform Of Environmental Compliance

The first category Staff seeks to disallow is advertisements designed to inform consumers of Aqua's laboratory results as to compliance with drinking water regulations. The regulations in question are those promulgated by the Illinois Environmental Protection Agency ("IEPA") under the federal Safe Drinking Water Act. As such, the regulations directly impact the quality of water that consumers drink and Aqua believes consumers want to be informed of whether their water utility has satisfied the IEPA's Safe Drinking Water standards. (Aqua Ex. S-2.0, p. 23).

Staff asserts that consumers should simply expect their water company to be in compliance with the IEPA's standards. (Staff Ex. 6.0, p. 17). If regulatory compliance were a given, however, there would be no need for the IEPA to routinely monitor compliance.[11] Moreover, the IEPA itself has deemed the results of each utility's test to be information about which consumers should be informed. (Aqua Ex. S-2.0, p. 23). The IEPA requires utilities to release their results in an annual Consumers Confidence Report. (*Id.*)

While Aqua recognizes the IEPA report makes the information public, a released regulatory report simply does not reach most consumers. Mass media is the only way that consumers truly receive the information on a large scale. Accordingly, Aqua believes this category of advertisements is beneficial and informative to consumers.

Staff asserts, nonetheless, that Section 9-225 of the Public Utilities Act ("PUA") sets the Standard for Recovery. (Staff Ex. 2.0, p.18). Aqua does not agree with Staff that Section 9-225 of the Public Utilities Act ("PUA") governs the recoverability of advertising expenses by water utilities because Section 9-225, by its express language, does not extend to water utilities. 220 ILCS 5/9-225(2). However, even if the Commission applies the Section 9-225 standard, it is

[11] Certainly, it cannot be argued that no utility has ever failed its compliance test.

difficult to conceive of an interpretation of the statute that would disallow utilities' recovery of expenses for advertisements designed to inform consumers of the quality of their drinking water. The Commission should reject Staff's proposal to disallow Aqua's recovery of these expenses.

ii. Advertisements To Inform Of Existing Rates

The second category Staff seeks to disallow is advertisements designed to inform customers of existing water rates. In particular, consumers are informed that a gallon of water costs less than one cent. (Aqua Ex. S-2.0, p. 24). Aqua believes that consumers are very interested in the amount of money they spend on utility services and what safeguards are in place to maintain low rates. While utility rate information is available through tariffs, such regulatory filings (like the IEPA's Consumers Confidence Report) simply do not attain large market saturation. As Mr. Schreyer testified, many consumers are unaware of the rate regulations the Commission imposes on the Company. (*Id.*)

Accordingly, Aqua believes this category of advertisements also informs consumers of useful and desired information. In fact, Section 9-225 of the PUA, while inapplicable to water utilities, expressly states that "explanations of existing ..rate schedules" is a category of advertising that "*shall* be considered allowable." 220 ILCS 5/9-225 (3)(f)(emphasis added). The General Assembly's mandate, *i.e.*, "shall," as to recovery of this type of expense for other utility types is a strong indication that such expenses should be recovered by all utilities. Staff's proposal to disallow recovery of this category of advertisements also should not be adopted.

iii. Advertisements To Inform Of Projects Impacting Service Quality

Advertisements in the third category are those designed to inform customers of projects that will impact the quality of service. In particular, Aqua notifies consumers of upcoming projects pertaining to the replacement of infrastructure and the improvement of the system, which projects reduce service interruptions and improve safety. (Aqua Ex. S-2.0, p. 24). Aqua believes consumers want to be informed that a portion of their existing rates is used to maintain and improve the system that provides them with their daily water. (*Id.*) Indeed, Section 9-225 states that advertising regarding "service interruptions" and "safety measures" is recoverable. 220 ILCS 5/9-225 (3)(c). The Generally Assembly clearly recognizes service interruptions and safety as issues about which consumers desire to be informed. Aqua's advertisements, which inform consumers that proactive steps are being take to avoid these events, do provide important information to consumers and should be recovered.

b. Aqua's Newspaper Advertising Increase Is Necessary To Sufficiently Inform Consumers

Staff's proposal to disallow Aqua's increase in newspaper advertising expense should be rejected. The $3,000 increase is necessary to sufficiently inform consumers of several scheduled, large projects that will impact both service and water quality. (Aqua Ex. S-2.0, pp. 24-25). In particular, a new 1 million gallon elevated tank is being constructed that will temporarily affect water pressure for the entire North end of Danville. (*Id.*) Without sufficient advertising, consumers will have no idea what is causing the change in water pressure that they will experience. (*Id.*, p. 25). Aqua also is constructing a new iron removal plant in Indianola that will have a positive affect on the characteristics of consumers' drinking water, *i.e.*, increased iron levels will be removed. (*Id.*) Advertising is the most effective means available to inform consumers of these planned events. (*Id.*)

Mr. Schreyer testified that repeat advertisements will be necessary for these planned projects to ensure that a sufficient level of market saturation occurs. (*Id.*) Mr. Schreyer's testimony is bolstered by a Community Advisory Panel, a group of Aqua's customers with the purpose to advance the interests of the Vermilion community, whose opinion is that in the past

Aqua's level of advertising to inform consumers of ongoing projects has been *inadequate.* (*Id.*) The opinion of such a community interest group that consumers should be informed of these events and that the level of past advertising designed to do so was inadequate is significant. Aqua's $3,000 budget increase intended to provide consumers with adequate advertising of projects that will impact both water quality and water service should be approved.

6. Charitable Contributions: Staff's Adjustment Would Disallow Expenses That Satisfy The Statutory Standard For Recovery

The PUA provides a statutory standard applicable to water utilities for the recovery of charitable contributions:

> It shall be proper for the Commission to consider as an operating expense…donations made by a public utility *for the public welfare* or *for charitable scientific, religious or educational purposes,* provided that such donations are reasonable in amount.

220 ILCS 5/9-227 (emphases added). Staff does not challenge the reasonableness of the amount of any of Aqua's charitable contributions and, as such, the dollar level of Aqua's contributions is not at issue. However, Staff proposes to disallow fourteen of Aqua's charitable contributions in their entirety based on Staff's subjective opinion that the contributions do not satisfy the standard for recovery. In forming its opinion, Staff did not talk with the organizations to which Aqua donated money to determine how the organizations actually used the donations. (Tr., pp. 268-70). Staff's subjective opinion that the donations were not used for the purposes set forth in Section 9-227 is not supported by the evidence.

a. Danville Area Economic Council ($10,000)

Staff asserts that Aqua's donation to this organization constitutes quarterly dues that are no different than membership dues in a social or service club. Staff alleges the dues enable

Company "employees to keep in contact with other members of the business community." (Staff Ex. 6.0, p. 21). Staff's claim simply is not correct.

Initially, it is important to note that no evidence supports Staff's allegation that the purpose of Aqua's donation is business networking. When asked if she knows how the Danville Area Economic Council uses Aqua's donation, Staff witness Ms. Ebrey replied: "No." (Tr., p. 268). Aqua witness Mr. Schreyer testified to the actual purpose of the donation:

> *[T]his contribution is used for the recruitment of future business to the Danville area*. The Danville area has lost several large industries over the past years. However, through the work of the Economic Council, Danville has been able to recruit a few new businesses in place of those lost. It is imperative that the Danville area continue to find new industry and keep the existing industry from leaving. *This contribution assists in enabling the Economic Council to continue to search for new industry, which has an impact on all of the residents of the area*. It is also critical for the Company that Danville maintain its existing industries as well as obtain new industry. Without this organization, *any industry lost would have a negative impact on the water customer*. Therefore, this contribution is critical for the viability of the Danville area.

(Aqua Ex. R-2.0, p. 33). Clearly, the *public welfare*, which is the statutory standard, is served by this contribution because it is used toward maintaining the prosperity and economic viability of the community. All consumers benefit from the industrial and economic development of the community the donation supports. In fact, consumers even benefit through their water rates because the community development drives an increase in the number of water customers who share in the overall cost of the system. (*Id.*)

Mr. Schreyer also responded directly to Staff's erroneous allegation that the donation is made to provide Aqua's employees with a social and community networking forum. He testified unequivocally that "Aqua receives no such gain from its payments to the Danville Area Economic

Council." (Aqua Ex. S-2.0, p. 27). Staff introduced no evidence from which the Commission could conclude otherwise. The expense should be recovered.

b. Donations To Support Community Events And Other Purposes ($15,450)

Staff claims that eleven of Aqua's contributions are in the form of sponsorships and made solely to promote Aqua's image and goodwill. (Staff Ex. 6.0, p. 21). The organizations to which some of these donations are made have included a small recognition of the Company in event programs in thanks for the contributions. Aqua has never asked any organization to include such recognition. (Aqua Ex. S-2.0, p. 28). Nor would Aqua have any reason to engage in such self-promotion because, as discussed *supra*, it does not need to encourage consumers to use its service. (Aqua Ex. R-2.0, p. 27). As such, the purpose of Aqua's donations is not to receive these token recognitions. Rather, Aqua's intent in making the donations is to advance each organization's purpose, each of which Aqua believes benefits the public. (Aqua Ex. S-2.0, p. 28).

The actual purpose of each of the eleven donations is as follows:

- American Legion ($1,000) – to provide a 4th of July celebration in honor of veterans;
- Danville Area Chamber of Commerce ($500) – to welcome new residents to the area;
- Danville Area Community College ($1,750) – to hold the National Junior College Basketball Championships;
- Danville Boat Club ($500) – to hold the community Splash and Dash event;
- Danville Stadium ($600) – to house approximately 200 games annually for local youth;
- Danville Symphony Organization ($500) – to support the symphony's operations;
- Downtown Danville, Inc. ($600) – to provide free music concerts for area residents;
- Kiwanis Club ($1,500) – to provide community children's programs;
- Lake Vermilion Water Quality Coalition ($5,000) – to protect Lake Vermilion's watershed and promote education about protecting the watershed;

- Peer Court, Inc. ($500) – to teach area youths how to resolve disputes responsibly;
- Vermilion County Conservation District ($3,000) – to stock Lake Vermilion with fish and improve water quality.

(Aqua Ex. R-2.0, pp. 31-34). In total, the community events that these donations are used to support benefit the public welfare, which again is the statutory standard, in several respects. First, the events draw a substantial number of visitors to the community, which in turn promotes the local economy and benefits all area residents and consumers. (*Id.*, p. 34). Second, the events support a balanced lifestyle for area residents, again drawing people to the area. (*Id.*) Third, the additional residents and industry expand the customer-base who share in supporting the water system. (*Id.*, pp. 34-35).

It is important to recognize that several of these donations also provide additional benefits. The Kiwanis Club and Peer Court donations do much more than support community events. The contributions support programs designed specifically to advance the well-being of children and area youth. It is difficult to see how Staff can argue that providing a $1,500 donation to Kiwanis Club for community children's programs does not benefit the public welfare. The donation to Peer Court also falls within a second category of the statutory standard in that it is for an *educational purpose*. These two donations fall squarely within the statutory definition of recoverable contributions.

Likewise, Aqua's donations to the Lake Vermilion Water Quality Coalition and Vermilion County Conservation District are recoverable. Aqua's donations to these organizations, $5,000 and $3,000 respectively, have been instrumental in improving the water quality of Lake Vermilion and in educating the public to protect the watershed. (Aqua Ex. R-2.0, p. 34). Again, it is difficult to see how Staff could argue that such a purpose of environmental protection and conservation does not promote the public welfare. In fact, Staff presented no evidence to the contrary. These donations, moreover, also fall within other categories of the statutory standard in that they serve both scientific and educational purposes. The Commission should allow recovery of these important contributions as the General Assembly intended.

c. Educational Scholarships ($2,225)

Staff seeks to disallow a third category in which two donations fall on the basis that the donations were not made to charitable payees–*i.e.*, Staff alleges that student recipients are not charities. (Staff Ex. 6.0, p. 22). The statutory standard for recovery set forth in the PUA, however, does not require a charitable recipient to come in any particular form. There is no requirement that a recipient be an organization in order to be the beneficiary of a charitable contribution. The standard is only that the donation be made "for the public welfare or for charitable scientific, religious or educational purposes." 220 ILCS 5/9-227.

Moreover, even though individuals may be the ultimate recipients of the contributions, the donations benefit the community in its entirety. For example, the College Scholarships are awarded to two high school seniors for outstanding achievements and taking a role in protecting the environment. (Aqua Ex. R-2.0, p. 32). As Mr. Schreyer testified:

> The students chosen for the contributions are selected based on their performance in school and in the community. Accordingly, these contributions promote leadership and social skills in all of the students who compete for these scholarships throughout Vermilion County's schools and have the potential to be awarded the scholarships.

(Aqua Ex. S-2.0, p. 29). The whole community benefits from the development of youth.

Finally, Staff has not asserted, nor could it, that the public welfare is not benefited by these contributions. These contributions also are recoverable because they are made for educational purposes and, in the case of the College Scholarships, with the purpose of protecting the environment. As the statutory standard is clearly satisfied, recovery should be allowed.

7. Rate Case Expense: Aqua Has Fully Supported This Known And Measurable Change

Aqua updated its estimate for rate case expense from $220,740 to $322,740. (Aqua Ex. R-2.0, p. 39). The basis for the update is the actual cost of outside legal fees being incurred as a result, in large part, of responding to a plethora of Staff data requests. (*Id.*, p. 40). The revised number represents an estimated total of $150,000 in legal fees. (Aqua Ex. S-2.0, p. 30). Invoices totaling $108,048.37 of actual legal fees incurred through the end of October, 2004, were introduced during hearings. (Aqua Ex. H-2.0). Mr. Schreyer testified that additional fees will be incurred for the hearing and briefing stages of the case, thus supporting the $150,000 total estimate. (Tr., pp. 81, 94-95).

The increase in fees has been driven by an unanticipated and significant amount of discovery, the complexity of the issues and Staff's decision to re-litigate many issues resolved by the Commission in earlier Aqua rate cases, *e.g.*, incentive compensation and a risk adjustment for Aqua's NAIC-2 rating. Aqua also has been forced to litigate issues such as the non-existence, *i.e.*, prove a negative, of an alleged double inclusion of Collection Fees within its 2005 budget. All these factors have driven increases in legal expenses.

Aqua respectfully requests recovery of its updated rate case expense of $322,740 in recognition of this known and measurable change. This amount would be amortized over three years at $107,580 annually. (Tr., p. 78).

8. Working Capital: This Item Should Be Based On Final Operating Expenses

Aqua agrees with Staff on the method for deriving Cash Working Capital. However, it needs to be based on final Commission-approved Operating Expenses. In particular, final Operating Expenses times 12.50% equals Cash Working Capital. (Aqua Ex. S-2.0, p. 3).

9. Interest Synchronization: This Item Should Be Based On Final Rate Base And Final Weighted Debt Cost

Aqua also agrees with Staff on the method for deriving Interest Synchronization. However, like Cash Working Capital, it will need to be calculated based on the Commission's final determinations. Final allowed Rate Base times final Weighted Debt Cost equals Interest Synchronization. (Aqua Ex. S-2.0, p. 3).

C. Rate Of Return

1. Capital Structure, Cost of Preferred Stock And Cost of Debt

For purposes of this case, the Company is accepting Staff's proposed capital structure, cost of preferred stock and cost of short- and long-term debt.

2. Cost of Common Equity

a. Aqua Has Fully Supported A Common Equity Cost Rate Of 10.75%

Ms. Pauline Ahern, who is a Vice President of AUS Consultants, author of several published articles on rate of return issues and recipient of the "Certified Rate of Return Analyst" designation, testified that an appropriate cost of common equity for Aqua is actually much higher at 11.35%. (Aqua Ex. 3, pp. 1-3). Ms. Ahern arrived at her conclusion by employing industry-approved methodologies for determining the common equity cost rate of a company whose common stock is not publicly traded and cannot be determined directly. In particular, she identified a proxy group of company whose risks, while not exact, were relatively comparable to Aqua's. (*Id.*, p. 4-5). She then performed analyses utilizing four well-tested cost of common equity models, the Discounted Cash Flow ("DCF"), the Risk Premium Model ("RPM"), the Capital Asset Pricing Model ("CAPM") and the Comparable Earnings Model ("CEM"). (*Id.*, p. 5). Finally, Ms. Ahern adjusted the results of her analysis to reflect the additional risks faced by Aqua that are not represented within the proxy group by adding an investment risk premium. (*Id.*, pp. 5-6).

Ms. Ahern fully responded to and rebutted Staff's asserted critics of her analysis. (Aqua Ex. R-3.0, pp. 15-40; Aqua Ex. S-3.0, pp. 1-13).

b. The Evidence Demonstrates Staff's Common Equity Rate Is In Error

Staff recommends a Cost of Common Equity equal to 10.07%. (Staff Ex. 7.0, p. 2). Ms. Ahern explained, however, that Staff's analysis has major flaws that created a serious downward bias. (Aqua Ex. R-3.0, pp. 2, 7-15).

Staff's analysis is also erroneous because it has two major inconsistencies with the Commission's recent holdings in Docket No. 03-0403. First, Staff refuses to apply the Commission's decision to add an investment risk premium of 30 basis points ("bps") to the results of Staff's analysis in recognition of the addition risk reflected by the National Association of Insurance Commissioners ("NAIC") rate of 2 on certain of Aqua's debt issues. (Aqua Ex. R-3.0, pp. 6-7). Second, Staff's does not adjust its analysis to reflect the higher interest rate environment since the Commission's Order in Docket No. 03-0403. (*Id.*, pp. 4-6). If the Commission accepts Staff's proposed common equity cost rate, which it should not, then each of these errors should be corrected.

i. Staff's Downward Bias

Ms. Ahern testified that Staff's analysis contains the following serious flaws: a virtually exclusive reliance on the DCF model, reliance on spot prices, the use of incorrect betas, the use of an inadequate sample selection criterion and a failure to account for known risks unique to Aqua as opposed to the proxy group. (Aqua Ex. R-3.0, pp. 7-15). Each of these flaws is addressed in turn.

First, Staff's virtually exclusive[12] reliance on the DCF model is problematic because the DCF model has a serious tendency to "mis-specify [and *understate*] investors' required return rate when the market value of common stock differs significantly from its book value." (*Id.*, p. 8). It does so because market prices reflect investors' assessments of long-range market price growth potential, which are not reflected in the growth rate proxies. (*Id.*) At the year end 2003, the market-to-book ratio of the S&P 500 Composite Index was 289.0%, which is significantly greater than unity. (*Id.*) This is clear evidence that a DCF-derived total market return will grossly understate the true investors' required return for the S&P 500 and, thus, both Staff's equity risk premium as well as Staff's common equity cost rates. (*Id.*) For this reason as well as the fact that the intent of the analysis is to simulate investors' (who have knowledge of all common equity cost models) required rates of return,[13] multiple, independently derived models of common equity cost rates should form the basis for any analysis. (*Id.*)

Second, Staff's use of spot market prices results in inaccuracies. The intent in utility ratemaking is to base a revenue requirement on normal operations and attempts should be made to estimate a utility's normal capital costs. (*Id.*, p. 9). Spot prices, however, are affected by temporary market aberrations that impact the market prices for the proxy group. (*Id.*) This is especially true in today's environment when the water and other utilities in the proxy group are large, geographically diverse holding companies impacted by substantial merger/acquisition activity. (*Id.*) Staff's use of spot prices, therefore, "does not accurately reflect the cost rate of common equity of the *operating, regulated* water utility on an ongoing, continuing basis." *(Id.* (emphasis in original)).

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[12] Although Staff also employs a Risk Premium Analysis, which is really a CAPM analysis, it is dependent upon the DCF model. (Aqua Ex. 3.0, p. 7).

[13] *See* Staff Ex. 3.0, p. 30 (Staff witness Ms. Phipps agreeing that "cost of common equity measurement techniques necessarily employ proxies for investor expectations").

Third, Staff's independent calculation of betas causes disparities from the investors' required common equity cost rate that the analysis is intended to emulate. (*Id.*, p. 13). Merrill Lynch publishes betas that are widely available to the public and relied upon by investors. (*Id.*) Staff's decision to rely on betas not utilized by the investment community necessarily will cause errors in Staff's analysis. (*Id.*) Moreover, Staff utilizes the S&P 500 as the basis for its independently derived betas whereas the Merrill Lynch betas are based on the NYSE Composite Index, causing Staff's data to vary even more from that relied upon by investors. (*Id.*)

Fourth, Staff has not made sufficient adjustments to account for Aqua's greater risk than that represented by Staff's proxy groups. (Aqua Ex. R-3.0, pp. 10-13; Aqua Ex. S-3.0, p. 4). As Ms. Ahern explained, the relevant risk reflected in the cost of capital must be that of Aqua Illinois because it is the regulated utility against whose rate base the overall cost of capital will be applied. (Aqua Ex. R-3.0, p. 10). The utility's size is an important factor in assessing the risk adjustment to be applied because smaller companies have increased risk, a fact that the financial literature widely accepts. (*Id.*, pp. 10-11). Smaller companies have significantly less liquidity and increased information, *i.e.*, transaction, costs. (*Id.*, p. 12). The evidence establishes that Aqua Illinois is significantly smaller than all of the companies in Staff's proxy group, yet Staff fails to adjust its results to fully account for Aqua's increased risks its small size represents. (*Id.*, pp. 11-12). Staff's common equity cost rate is, therefore, even further understated because Staff does not apply a proper risk premium of 35 bps to account for Aqua's size. (*Id.*, pp. 12-13).

Finally, the serious downward bias of Staff's analysis is revealed by the fact that Staff proposes a long-term debt cost rate of 7.48%, which implies equity risk premia of only 2.59% (10.07% - 7.48% = 2.59%). (*See Id.*, p. 15 (updated to reflect Staff's addition of 7 bps on rebuttal)). An appropriate risk premium for A rate public utility bonds[14] is in the range of 3.5%/3.7% and 3.9%. (*Id.*) As Ms. Ahern concluded, "[a]n implied equity risk premia on the order of [2.59%] is clearly inconsistent and inadequate." (*Id.*)

ii. Staff's Failure To Add 30 Bps To Reflect Aqua's NAIC-2 Rating

In Docket No. 03-0403, the Commission found that the NAIC-2 rating for several of Aqua's debt issuances reflected the presence of additional risk that Staff had not recognized in its analysis. The Commission stated:

> In this context, it is appropriate to consider all available information of record, including the rating of NAIC-2 on certain of [Aqua Illinois'] securities issues. When compared to the credit rating of A discussed earlier, the rating of NAIC-2, or a comparable S&P rating of BBB, indicates the presences of some additional risk factor not already explained.

(Order, Dkt. No. 03-0403, p. 43). The Commission further held that an additional risk premium of 30 bps should be added to Staff's analysis to account for the presence of Aqua's additional risk not reflected within Staff's analysis. (*Id.*) The Commission made this ruling in April of this year, just six weeks before Aqua filed its tariffs initiating this proceeding.

The evidence in this case also establishes the NAIC-2 rating assigned to Aqua's debt issuances.[15] (Aqua Ex. 3.0, p. 14). Consistent with the Commission's finding in Docket No. 03-0403, Ms. Ahern testified that an NAIC-2 rating "is equivalent to Moody's Baa1, Baa2, and Baa3 and S&P's BBB+, BBB, and BBB- bond ratings." (*Id. citing* Appendix A, Section 4, "list of Nationally Recognized Statistical Rating Organizations and the Rating Equivalent of their Systems to NAIC Designations, pp. A-13 and A-14). As the Commission held in Docket No. 03-

[14] Aqua Illinois in comparison has risk equal to an S&P rating of BBB. *See*, Order, Dkt. No. 03-0403, p. 43 (the Commission recognizing the NAIC-2 rating on Aqua's securities issues as comparable to a credit rating of BBB).

[15] Aqua also provided Staff copies of reports reflecting the NAIC-2 rating assigned to Aqua's recent debt issuances. (Aqua response to Staff Data Request FD-33).

0403, Ms. Ahern concluded that the NAIC-2 reflects additional risk that is not accounted for in the proxy groups utilized by either Ms. Ahern or Staff. (*Id.*, pp. 14, 63-64; Aqua Ex. R-3.0, pp. 6-7).

Yet, Staff refuses to conduct an analysis in this case that incorporates this aspect of the Commission's holdings in Docket No. 03-0403. (Aqua Ex. R-3.0, pp. 6-7). Staff's refusal to do so results in a direct inconsistency between Staff's analysis and the Commission's Order in Docket No. 3-0403. If the Commission adopts Staff's analysis, which it should not, then at a minimum the Commission should act consistently with its holdings in Docket No. 03-0403 by adding 30 bps to Staff's recommended common equity cost rate of 10.07% (10.07% + 0.30% = 10.37%) to account for the additional risk reflected in the NAIC-2 rating assigned to Aqua's debt issuances.

iii. Staff's Failure To Account For Increased Interest Rates

The Commission also found in Docket No. 03-0403, after extensive litigation, that a proper common equity cost rate for Aqua was 10.16%. The Commission's order was issued in April, 2004 and, thus, reflects a finding that the 10.16% rate was proper within the context of the interest rate environment existing at that time. At that time, Moody's A rated public utility bond yields averaged 5.97% and Baa rated public utility bond yields averaged 6.12%. (Aqua Ex. R-3.0, p. 5).

The evidence demonstrates that, since that time, interest rates have been rising. (*Id.*) For the month of August, 2004, "Moody's A and Baa rate public utility bond yields averaged 6.14% and 6.45% respectively, an increase of 0.17% (17 bps) and 0.33% (33 bps)" respectively. (*Id.*) Interest rates, moreover, are expected to continue rising. Ms. Ahern testified:

> 20-Year U.S. Treasury bonds were yielding an average 4.80% for the week ending September 24, 2004 according to the October 1, 2004 *Blue Chip Financial Forecasts* ("*Blue Chip*") and are expected by *Blue Chip* to rise to an average 5.1% for the fourth quarter of

> 2004, continuing to rise to an average 5.8% for the first quarter of 2006, a total increase of 1.00% (100 bps). In addition, Moody's Aaa corporate bonds yielded an average 5.37% for the week ending September 24, 2004 and are expected by *Blue Chip* to rise to an average 5.8% in the fourth quarter 2004 and to an average 6.6% for the first quarter of 2006, for a total increase of 1.23% (123 bps). In addition, *Blue Chip* expects the prime rate to rise to 6.6% by the first quarter 2006 from an average 4.57% for the week ending September 24, 2004, representing a 2.03% (203 bps) increase.

(*Id.*)

Ms. Ahern explained that, because the Commission adopted 10.16% rate (which included the 30 bps adjustment to Staff's analysis for NAIC-2 rating) reflected the lower interest rate environment existing in April, 2004, an adjustment is necessary to reflect the Commission's finding within the context of today's increased interest rate environment. (*Id.*) She further explained that the increase in the Moody's Baa rated public utility bond yields is the proper basis for the adjustment due to Aqua's NAIC-2 rating. Hence, capital costs, including the cost of common equity, have increased by up to 0.33% since the Commission adopted 10.16% as the authorized rate of return on common equity in Docket No. No. 03-0403 in April 2004. (*Id.*)

Staff's analysis is clearly biased downward to the point of error because it results in a common equity cost rate (10.07%) that is not only below the Commission's adopted rate in Docket No. 03-0403 as adjusted to reflect today's higher interest rates (10.49%), but it is even below the Commission's adopted rate in Docket No. 03-0403 (10.16%), which reflected the lower interest rate environment existing in April, 2004. It is not appropriate for common equity cost rates to decrease as interest rates increase. The Commission should recognize this serious flaw in Staff's proposal. Accordingly, to the extent the Commission is inclined to rely on Staff's analysis, which it should not, the Commission should instead rely on its findings reached after extensive litigation of this issue in Docket No. 03-0403 as adjusted to reflect today's significantly higher interest rate environment by adopting a common equity cost rate of 10.49%.

D. Rate Design

1. Fourth Usage Block

Provided the Commission accepts the relation between the first three usage block rates that Staff proposes (Staff Ex. 8.1, p. 1), then Aqua has decided not to contest Staff's proposal to eliminate the fourth usage block.

2. Customer Charge

Staff proposes to maintain customer charges, with the single exception of the customer charge applicable to Teepak, at current levels. The Commission should not adopt Staff's proposal for three reasons.

First, at a minimum, all customer charges should be adjusted to include the Qualifying Infrastructure Plant Surcharge ("QIPS").[16] The QIPS is designed to recover Aqua's investment in qualifying infrastructure that occurs between rate cases. Ill. C.C. No. 47, Sec. No. 8, Original Sheet No. 15 (eff. Jan. 1, 2002). It is a set percentage, currently 5%, applied to all customer bills. (*Id.*; *see also*, Staff Ex. 4.0, p. 12 (noting the current percentage)). At the time of a rate case, the QIPS is eliminated as a separate line item, *i.e.*, reduced to zero, because the qualifying infrastructure is rolled into ratebase.[17] (Staff Ex. 4.0, p. 12; Tr., pp. 180, 197-98). Accordingly, Aqua witness Mr. Monie testified that the amount previously represented as a fixed percentage QIPS on customer bills should be rolled into each customers' customer charge. (Aqua Ex. S-4.0, p. 3). So, for example, the current rate for a customer with a 5/8" meter of $12.00 should be

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[16] The QIPS is percentage is currently equal to 5%. (*See e.g.*, Tr., p. 179).

[17] Any future QIPS will only recover Aqua's investment in new qualifying infrastructure that satisfies the terms of Aqua's tariff and is constructed after the close of this case.

adjusted to $12.60. (*Id.*) Indeed, Mr. Monie explained that Staff's proposal not to roll the QIPS into the customer charge, *i.e.*, to leave the charge for customers with 5/8" meters at $12.00, could result in a rate *decrease* for those customers depending on their usage. (*Id.*)

Second, Staff's proposal constitutes a radical tariff design change. Leaving the customer charge stable while increasing meter charges, *i.e.*, usage, a customer who uses 100 cf per month would have a 6.5% increase but a customer who uses 800 cf per month would have a 11.2% increase. This is a substantial change in customers' proportionate cost burdens. (*Id.*, pp. 3-4).

Third, Staff's proposal would alter Aqua's overall rate design. The current customer charge for Teepak and for other customers with 6" turbine meters is $421.00 ($442.05 adjusted for QIPS) and $505.00 ($530.23 adjusted for QIPS), respectively. Staff proposes to increase Teepak's customer charge by 40.4% while leaving other customer charges stable, without even adjusting for QIPS. This would reverse the comparative order of the customer charges in that it would produce a customer charge for Teepak of $591.29, which is $86.29 or 17.1% higher than the current rate of $505.00 applicable to other customers with 6" turbine meters. (*Id.*, p. 4).

As a compromise, Aqua proposes increases to customer charges that are calculated by adding proportionate amounts of the difference between the overall charges for Teepak that the Commission approves and the actual cost to serve Teepak. In particular, Staff's cost of service study sets the cost of serving Teepak at $1,065,639. (Staff Ex. 8.1, p. 12). Aqua proposes to charge Teepak a total of $483,503 and Staff proposes to charge $639,002, which charges would result in differences from the cost of service of $582,136 and $426,637, respectively. These differences, expressed as percentages, are 5.8% and 4.2%, respectively. An appropriate compromise would be the application of these percentages to each customer charge (including QIPS). For example, the charge for customers with 5/8" meters would be either $13.33 ($12.60 x

5.8%) or $13.13 ($12.60 x 4.2%), based on Aqua's and Staff's recommended overall charges for Teepak, respectively.

3. Large Industrial Customer Class Rate – Teepak

The most significant tariff design change that Staff proposes is a radical increase in the meter rates applied to Teepak.[18] Staff proposes to increase Teepak's rate by $175,417 or 38.5% *exclusive* of the 5% QIPS. (Aqua Ex.R-4.0, p. 5). This proposal should absolutely be rejected.

The evidence demonstrates that Teepak is highly concerned about the expense it incurs for water service. Mr. Mark Niedenthal, who is Teepak's utilities engineer, testified that due to these concerns Teepak began taking significant steps as early as 1997 to facilitate its exit from Aqua's system. (Aqua Ex. R-5.0, pp. 1-2). These steps have included repeat consultations with specialists, who have designed and developed cost models for a Teepak stand-alone well water treatment plant. (*Id.*, pp. 3-4). Teepak has also obtained the easements that would be necessary for the construction of a pipeline from the wells to the well water treatment plant. (*Id.*, p. 5). The seriousness of Teepak's consideration is further reflected by the involvement of Teepak's upper management in the issue. (*Id.*, p. 3). While Teepak is not interested in entering the water business, Mr. Niedenthal testified that if the Commission for some reason approves Staff's 38.5% rate increase proposal, then Teepak would take the following steps:

> In the event that the rate increase proposed by Staff is approved by the Commission, Teepak would begin a detailed review of the Teepak well water project costs and return on investment. A request for capital would be submitted to Teepak upper management for review and consideration for approval.

(*Id.*, p. 6). No evidence that Teepak would respond any differently exists.

[18] Teepak is the only customer that qualifies for the Large Industrial Customer Class rate. (Aqua Ex. R-4.0, p. 5).

Aqua witness Mr. Monie testified that "the risk of Teepak no longer being a customer…far outweighs the lower than fully allocated cost of service of Teepak's water rate." (Tr., p. 184). Mr. Monie explained that customers will have a minimal—less than 1%—rate impact if Teepak is granted a 6% total increase, (Aqua Ex. R-4.0, p. 8), whereas ratepayers will be worse off if Teepak actually does leave Aqua's system. As Staff agrees, other consumers would pay either 4.4% or 6.3% more under Company and Staff proposed rates, respectively, should Teepak leave. (Aqua Ex. S-4.0, p. 5; Staff Ex. 8.0, p. 11). It is undisputed, therefore, that all customers will have lower rates if Teepak remains on the system. (Aqua Ex. S-4.0, pp. 5-6).

It is appropriate to consider this factor when designing rates. (Aqua Ex. R-4.0, pp. 7-8). Mr. Monie testified that the American Water Works Association M1 Manual "Principles of Water Rates, Fees, and Charges" (Fifth Edition) ("M1 Manual"), which is considered highly authoritative on rate design, provides that a rate structure should be responsive to the needs and objectives of the community, and that it is proper to design rates to "support a community's social, economic, political and environmental concerns." (*Id. citing* M1 Manual, p. 79). Accordingly, Mr. Monie engaged in extensive discussions with both Teepak and community representatives, like its elected officials, to assess the community issues relevant to rate design. (Tr., pp. 193-94, 201-02). The Danville community leaders have stated their objective to maintain Teepak as a viable company operating within the area, thereby employing community residents and driving the prosperity of the local economy. (*Id.*, pp. 6-7, Att. R4-2). The community leaders have requested that these important social and economic objectives be considered in the design of rates applicable within the community by limiting Teepak's rate increase to 1%. (*Id.*)

Staff acknowledges Mr. Niedenthal's testimony that Teepak would find a 38.5% rate increase shocking. (Tr., p. 281). Staff further acknowledges that Teepak has represented the state of its business for purposes of this case. (Tr., p. 292 (Aqua Cross Ex. 5 (Proprietary)).

Nonetheless, Staff wants the Commission to essentially call Teepak's cards on the chance Teepak will not leave Aqua's system despite a 38.5% rate increase. Under cross examination, Staff witness Mr. Luth testified:

> Q. I guess my question goes to at the end of the day is your proposal based on your assessment that Teepak will not leave the Aqua system with a 35 percent increase in rates?
>
> A. Yes.

(Tr., pp. 297-98). Staff comes to this conclusion without ever having engaged in discussions with Teepak's management to assess the seriousness of Teepak's stated intentions. (Tr., p. 285). Nor did Staff discuss the objectives of community leaders like the Mayor. (Tr., pp. 286-88).

Aqua witness Mr. Monie was unwilling to engage in such a game of chance, (Tr., pp. 189-90), and recommended the Commission not do so either. (Aqua Ex. 4.0, p. 5, Sch. 1, pp. 1, 6). He testified that he took Teepak's stated intentions at face value because he has no reason to doubt Teepak's seriousness.[19] (Aqua Ex. R-4.0, p. 6). Mr. Monie relied on Mr. Niedenthal's testimony as well as a letter from Teepak's President and Chief Executive Officer Mr. Paul Murphy as the basis for his opinion that Teepak is sincere about its decision to seriously evaluate leaving Aqua's system should Staff's proposal be adopted. (*Id.*, p. 6, Att. R4-2).

Mr. Monie opined, based on all these factors, that a limited increase in Teepak's rates, namely 1% (plus the 5% QIPS), is appropriate. In prior cases, even Staff has agreed:

> Q. Has Teepak [sic] provided evidence that they are capable of constructing an alternative water supply source at a cost that would require a lower rate to avoid Teepak from discontinuing water purchases from [Aqua Illinois, Inc.]?

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[19] Mr. Monie clarified that he was not rendering an opinion as to whether Teepak actually would or would not leave Aqua's system. (Tr., p. 195). He explained, however, that it is Teepak's opinion as to whether it can feasibly leave Aqua's system that matters because Teepak will be the entity that actually makes the decision. (Tr., pp. 188-90).

A. Teepak has submitted testimony and updated Exhibit 1A and 3A previously presented in Docket No. 97-0351, based on current cost and inflation estimates which reasonably demonstrates that they have investigated the feasibility of constructing an alternative water supply (DR Response REP 1.12). Furthermore, Teepak has stated that 'if the Large Service Rate approved by the Commission, increases by more than 2.5%, Devro-Teepak would begin detailed engineering to proceed with construction of its own water system. If Devro-Teepak is given a 0% to 2.5% increase in the Large General Service Rate filed, Devro-Teepak would stay on the system.' (DR Response REP 1.12, Ex. 2, pages 5-6).

Q. What are you proposing for Large General Service?

A. Teepak purchases approximately 15% of the water sold in the Vermilion service area, consuming 420 million gallons (DR Response REP 1.12, Exhibit 2, pages 5-6). In addition, they have already demonstrated in the last two rate cases (Docket Nos. 97-0351 and 94-0270), as well as this rate case, for Vermilion that they are ready and able to construct an alternative water supply and cease purchasing water from [Aqua Illinois]. Therefore, since the proposed rate will exceed out of pocket cost by a very considerable margin, I agree with [Aqua Illinois'] proposed increased rate of 2.5% for Large General Service, to relieve the remaining ratepayers from seeing a significant rate increase if Teepak were to cease purchasing water from [Aqua Illinois]. Simply stated, the remaining rate payers benefit from Teepak remaining on the system at a less than full cost of service rate since Teepak will still make a significant contribution to fixed cost.

(Staff Ex. 5.0, Pilapil Testimony, pp. 18-19, Dkt. No. 00-0339). Accordingly, Aqua recommends the Commission approve an increase for the Large Industrial Customer Class of 1% plus 5% QIPS.

III.
Conclusion

WHEREFORE, for each and every one of these reasons, Aqua Illinois, Inc. respectfully requests that the Commission enter an order consistent with the arguments set forth herein.

Dated: December 10, 2004

Respectfully submitted,

AQUA ILLINOIS, INC.

By: ________________________________
One of its attorneys

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CERTIFICATE OF SERVICE

I, John E. Rooney, an attorney, hereby certify that I caused to be served a copy of the Initial Brief of Aqua Illinois, Inc. upon the service list in Docket No. 04-0442 by email on December 10, 2004.

John E. Rooney